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IN THE

Supreme Court of the United States

October Term, 1962

No. _____

AMERICAN STATES INSURANCE COMPANY, - *Petitioner,*

v.

CRANE SUPPLY COMPANY, a Division of Crane Company, - - - - *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Petitioner, American States Insurance Company, prays that a Writ of Certiorari issued to review the Judgment entered in this case by the United States Court of Appeals for the Sixth Circuit on November 15, 1962 (Petition for Rehearing denied January 28, 1963) which affirmed the Judgment of the District Court of the United States for the Western District of Kentucky.

OPINIONS BELOW.

No Opinion was written by the District Court. The Judgment of the District Court is found at page 39a. The Opinion of the United States Court of Appeals for the Sixth Circuit is reported in 310 Fed. 2d 712 (C.A. 6th) and was set forth in the Certified Record following pages 45b.

GROUNDS ON WHICH JURISDICTION OF THIS COURT IS INVOKED.

The Judgment of the Court of Appeals sought to be reviewed (310 Fed. 2d 712 (C.A. 6th)), was entered November 15, 1962. Petition for Rehearing was filed December 15, 1962 and denied by an Order entered January 28, 1963. The statutory provision believed to confer jurisdiction on this Court is 28 *U.S.C.A.* 1254. Certiorari is sought because of the importance of this case to the field of surety law.

QUESTIONS PRESENTED FOR REVIEW.

1. In a diversity of citizenship case, is the law of Kentucky, under the doctrine of Erie Railroad Co. v. Tompkins, 304 U. S. 64, 58 S. Ct. 817, determinative when the cause of action arose in Kentucky?
2. Where an unpaid material supplier, who has furnished materials to a building contractor for use in the completion of a construction contract, agrees with the building contractor that the time of payment of his debt then due be extended at interest for a fixed period, is the extension of time supported by consideration so as to make it enforceable?
3. Where an unpaid material supplier, who has furnished materials to a building contractor for use in the completion of a construction contract (pursuant to the terms of which the building contractor has posted a materials and labor bond with compensated surety), at a time when the debt is past due, but the contractor is solvent, and

without any demand upon or notice to or knowledge of the surety, grants the building contractor an enforceable extension of time in which to pay the debt, does the extension of time prejudice the surety in its obligation on the bond if the contractor becomes insolvent during the extension period?

4. Where an unpaid material supplier, who has furnished materials to a building contractor for use in the completion of a construction contract pursuant to the terms of which the building contractor has posted a materials and labor bond with compensated surety, at a time when the debt is past due and without any demand upon or notice to the surety, and without the surety's knowledge, grants to the building contractor an enforceable extension of time which is prejudicial to the surety, is the surety thereby released from its obligation on the bond to the material supplier?

STATUTES INVOLVED.

There are no statutes involved.

STATEMENT OF THE CASE.

On April 5, 1960, Roy B. Sanders, a plumbing and heating contractor in Louisville, Kentucky, entered into two contracts with the Board of Education of Louisville, Kentucky. Pursuant to the terms of the first contract (10a-14a), Sanders was to furnish material and perform all of the work, shown on the drawings and specifications referred to in the contract, for

the installation of a new boiler in the Jackson Junior High School, 828 South Jackson Street, Louisville, Kentucky. The second contract (15a-19a), provided that Sanders was to furnish the material and perform the work, shown on the drawings and specifications referred to in the contract, for the installation of a new heating system in the Parkland Elementary School, 1309 Catalpa Street, Louisville, Kentucky. The provisions of the two contracts are essentially the same, except for the nature of the work to be done and the price Sanders was to be paid. Both contracts required Sanders to execute to the Board of Education a bond in a sum equal to the contract price, with corporate surety, to be approved by the Board for the faithful performance of the contract. These bonds are found at page 13a and page 18a of the Appendix, and the obligation assumed by Sanders and his surety, under the terms of each bond, is identical. For the Court's convenience, this obligation is set out herein as follows:

> "Now if said Principal shall well and truly keep and perform all and each of the terms, conditions and agreements of said Contract required therein to be kept and performed by said Principal, including the payment in full of all labor and material used in the completion of said contract, and shall pay all unemployment contributions which become due and payable under the Kentucky Unemployment Insurance law, then this obligation to be void, otherwise to remain in full force and effect."

The defendant, American States Insurance Company, by its duly authorized agent, executed both of these bonds as surety for the said Sanders.

Sanders performed both the above-mentioned contracts according to the plans and specifications (47a-48a). The plaintiff, a supplier of plumbing materials in Louisville, Kentucky, had sold materials to Sanders for use on these two contracts, and *also* for use on six or seven other contracts which Sanders was performing at the same time (67a). During October, 1960, Sanders' total indebtedness to the plaintiff for materals furnished on all of his jobs was the sum of Twenty-Nine Thousand, Nine Hundred Eighteen Dollars and Eighty Cents ($29,918.80) (55a, 61a, 100a). At this time, Sanders' account with plaintiff, for all of the jobs he was working on, was sixty to ninety days delinquent, and he approached Mr. E. A. Loeser, plaintiff's managing agent in Louisville (60a), and requested that the plaintiff allow him a ten months extension of time in which to liquidate his indebtedness (64a-65a). Loeser recognized the fact that Sanders had been a good customer, but told him that a ten months extension was too long, and that the most that could be granted would be three months (65a). Furthermore, Loeser informed Sanders that in the event the extension was granted, and plaintiff sold Sanders materials for the Hazelwood Sanitorium, a bonded job that plaintiff was quoting on at the time, that all new purchases would have to be discounted or paid for before the fifteenth of the month following the purchase (65a). Loeser, at Sanders' request agreed to

contact John Corman, the plaintiff's general credit manager for its supply division, in order that Sanders might talk to him about an extension of time (65a, 70a). Mr. Corman was Mr. Loeser's superior (71a). As a result, Mr. Corman made a trip from his office in Chicago to Louisville in order to confer with Sanders regarding his request for an extension of time in which to pay his indebtedness to plaintiff. As Mr. Corman remembered it, the conference took place at plaintiff's Louisville office "the first week in October or possibly the second week in October" (71a). The persons present at the conference were Sanders, Corman and Loeser (71a). At the meeting, Sanders again requested a ten months extension of time in which to liquidate his account with plaintiff, and in support of his request Sanders exhibited to Corman and Loeser his financial statement which reflected him to be in a solvent condition, with a net worth in excess of Forty-Two Thousand Dollars ($42,000.00). Sanders also told plaintiff's representatives that he had, at the time, considerable money tied up in retainage on jobs that were being completed and that most of this retained money would be payable to him within the next three or four months (72a).

As a result of this meeting, it was agreed that plaintiff would "hold the matter in abeyance" (72a) until Sanders received his retained money. In this connection, Mr. Corman required Sanders to execute four promissory notes payable to the plaintiff (73a). The total amount for which the notes were made was Thirty

Thousand One Hundred Ninety-Two Dollars and Sixty-Eight Cents ($30,192.68). Of this sum, Twenty-Nine Thousand Nine Hundred Eighteen Dollars and Eighty Cents ($29,918.80) represented Sanders' total unpaid account at the time, with the balance representing interest (77a) on the account from the date of the notes until the respective due dates set out on the face of each note (55a-56a, 101a). The notes were to be paid during the following ninety-day period, in which it was contemplated that Sanders would receive the money which was being held on retainage (73a).

In addition to requiring Sanders to execute these notes, with interest, the plaintiff further required him to agree that any payment he might make on the notes would be first applied to the portions of his total account not covered by the defendant's surety bond. In February of 1961, when Loeser's deposition was taken in preparation for the trial of the case, he testified that all note payments were to be applied to the unbonded accounts (65a-66a). However, at the trial, Loeser qualified his prior testimony to the effect that it was "inferred" that had Sanders specifically designated that money being paid was to be applied on a bonded account, then it would have been so applied by plaintiff (67a). As an actual fact, the money paid by Sanders on the notes was first applied to pay *in full* all of his other accounts, then to interest on the notes, and only after that, was any money applied to pay the Jackson or Parkland School accounts which were bonded by defendant (45a-46a).

The notes under discussion were filed in the record as defendant's exhibits 1, 2, 6 and 7 (99a, 102a). For convenience, they will be briefly described here:

Defendant's Exhibit No.	Date of Note	Amount of Note (Principal Plus Interest)		Date Payable
1 (99a)	Oct. 11, 1960	$ 5,000.00	on	Oct. 20, 1960
2 (99a)	Oct. 11, 1960	5,025.00	on	Nov. 5, 1960
7 (102a)	Oct. 11, 1960	10,100.00	on	Dec. 5, 1960
6 (102a)	Oct. 11, 1960	10,067.68	on	Jan 5, 1961

As mentioned above, Sanders paid the first note of Five Thousand Dollars ($5,000.00) (99a), the payment being admittedly received by the plaintiff on October 20, 1960. Mr. Loeser personally endorsed the receipt of payment on the face of the note (60a-61a). On November 8, 1960, Sanders paid the second note of Five Thousand Twenty-Five Dollars ($5,025.00) (99a), the payment also being personally acknowledged by Loeser by receipting same on the face of the note (61a). The third (defendant's exhibit 7, 102a) and fourth (defendant's exhibit 6, 102a) notes, their respective due dates being December 5, 1960 and January 5, 1961, were not paid by Sanders because in December of 1960 he instituted bankruptcy proceedings in the United States District Court for the Western District of Kentucky seeking an arrangement under Chapter XI of the Bankruptcy Laws with his creditors. Subsequently, when it became apparent that no arrangement would be possible with these creditors, Sanders amended his petition, requesting the Court to grant him leave to file a petition in voluntary bankruptcy. Sanders was adjudged a voluntary bankrupt on January 4, 1961

(see admission in paragraph 4 of complaint; 9a), and a Receiver was appointed by the abovementioned Court to take charge of his assets (see admission in paragraph 5 of complaint; 9a).

Between the time plaintiff took the notes from Sanders, which was October 11, 1960, and the time he petitioned the Court for a Chapter XI arrangement, Sanders collected in the regular course of his business, the sum of Thirty-Eight Thousand Twenty-Three Dollars and Twenty-Four Cents ($38,023.24) (59a).

On November 30, 1960, about a week before Sanders filed his petition in bankruptcy, the plaintiff, in view of Sanders' worsening financial condition, had its attorney notify the defendant surety that Sanders' account for the Parkland and also the Jackson Street School jobs was delinquent and that there was a balance due and owing plaintiff on the two jobs in the sum of Nineteen Thousand Four Hundred Forty-Two Dollars and Eleven Cents ($19,442.11) (95a-98a). This notice was received by the defendant on December 2, 1960 (95a), and was the first notice to the defendant that Sanders had failed to pay these accounts to the plaintiff, or that Sanders was in any way delinquent so that a claim could be made on the bonds (48a-52a). There was no notice to the defendant when the October 11, 1960 note agreement was made between plaintiff and Sanders (49a-50a). Mr. Corman, the general credit manager for plaintiff, admitted that when the notes were given, Sanders' account was seriously delinquent, but that he knew of no notice having been given to defendant of this fact at that time (83a-84a).

Pursuant to *Rule 36 of the Federal Rules of Civil Procedure*, American States served a Request for Admissions on the Crane Supply regarding the promissory notes. Copies of the notes which are in this Record as defendant's exhibits 1, 2, 6 and 7 (28a-32a) were attached to the Request for Admissions. The defendant requested the plaintiff to admit that the notes were true copies of those delivered by Sanders to the Crane Company on October 11, 1960, and that the handwritten notes on the note payable October 20, 1960 (30a) and also on the note payable November 5, 1960 (31a) was made by Mr. E. A. Loeser, Manager of the Crane Supply Company and that his signature was genuine. This notation was a handwritten receipt showing that each of these two notes had been paid by Sanders, and the plaintiff had received that payment. No response was received from the plaintiff with respect to this request for admissions within the prescribed ten-day period, and therefore, the Crane Company is deemed to have admitted that the notes executed by Sanders and delivered to the plaintiff were genuine, and that the first two of them had been paid by Sanders.

Supporting defendant's contention that Sanders and plaintiff had thus regarded the old account (represented by the notes) as paid, was the testimony of Mr. Norman Shelton, Sanders' bookkeeper (52a-53a). Mr. Shelton was the person in Sanders' organization whose responsibility it was to receive statements of accounts payable (57a). He testified that the first statement he received from the plaintiff after the notes

were given was one showing that Sanders owed the plaintiff nothing, and in fact, that the plaintiff owed Sanders a credit balance of Seventeen Dollars and Thirteen Cents ($17.13) (58a, 92a).

On the other hand, the plaintiff contended that the only purpose of the notes was to verify the amount of Sanders' indebtedness, and that there was no intention on plaintiff's part to regard the notes as payment of Sanders' account (81a). Mr. Corman did admit, however, that at the time the notes were given, Sanders had not contested the amount of his account (81a), and also, Corman admitted that the notes bore interest (77a) and that never before had any statement sent to Sanders reflected an interest charge (82a).

In view of the conflicting evidence on this point, the trial court submitted the case to the jury on an interrogatory, which set out the issue. This is quoted here for the Court's convenience (90a):

"Interrogatory No. 1.

"Do you believe from the evidence in this case that the plaintiff, Crane Supply Company, accepted the four (4) notes of Roy Sanders on or about October 11, 1960, in full payment of its accounts for materials furnished to Roy B. Sanders in connection with the Jackson Street and Parkland School improvements, about which you have heard testimony?"

The Jury, after considering the evidence for four hours and fifteen minutes, finally answered the interrogatory in the negative (trial order; 36a). Pursuant

to the verdict, the District Court entered judgment (39a) on May 17, 1961, in favor of the plaintiff and against the defendant in the sum of Nineteen Thousand Four Hundred Forty-Two Dollars and Eleven Cents ($19,442.11) with interest at 6% per annum from September 1, 1960.

Subsequently, the defendant moved the Trial Court for an order setting aside the verdict and judgment theretofore entered, and for judgment in accordance with its previous motion and grounds for a directed verdict (40a). The defendant's position was that regardless of the issue decided by the jury, that the agreement between Sanders and the plaintiff, involving the notes, which was made without notice to or knowledge of the defendant, was prejudicial to the defendant as surety, because it granted Sanders an enforceable extension of time to pay his then due indebtedness; that the extension of time was prejudicial to the defendant, and that therefore the defendant should be released on its obligation on the bond as a matter of law. The Trial Court was of the opinion that the extension of time, apparent on the face of the notes themselves, was not supported by consideration, and therefore was not enforceable; since the extension was not enforceable, it could not have been prejudicial to the defendant. Consequently, the defendant's motion for a judgment n.o.v. was overruled (42a).

REASON FOR THE GRANTING OF THE WRIT.

1. In a Diversity of Citizenship Case, Is the Law of Kentucky Under the Doctrine of Erie Railroad Co. v. Tompkins, 304 U. S. 64, 58 S. Ct. 817, Determinative When the Cause of Action Arose in Kentucky?

Under *Erie R. Company* v. *Tompkins*, 304 U. S. 64, 58 S. Ct. 817, the Rule is set down that in diversity of citizenship cases that the law of the State where the cause of action arose will be applied in the Federal Courts as to matters of substance. The Opinion of the Court of Appeals is adverse and contradictory to the *Erie Railroad Company* case in that it does not follow the law of Kentucky. In the Opinion, there is no reference to any Kentucky law—decision or statute. A reference to the briefs filed in the Sixth Circuit will show that this case was argued on the basis of Kentucky law. The sole question is whether or not under the Kentucky law the Trial Court correctly overruled the Insurance Company's Motion for a Directed Verdict and its Motion for Judgment Notwithstanding the Verdict. Thus, since the Court of Appeals made no attempt to apply Kentucky law, the reason the Certiorari should be granted is evident because of the failure of the Court of Appeals and the District Court to follow *Erie Railroad Co.* v. *Tompkins*, *supra*.

2. Where an Unpaid Material Supplier, who Has Furnished Materials to a Building Contractor for Use in the Completion of a Construction Contract, Agrees With the Building Contractor That the Time of Payment of His Debt Then Due Be Extended at Interest for a Fixed Period, is the Extension of Time Supported by Consideration so as to Make It Enforceable?

The Insurance Company's principal defense to this action is of the promissory notes given by Sanders, and accepted by the plaintiff, without any knowledge of or notice to defendant, creating an enforceable extension of time for Sanders to pay his indebtedness to the plaintiff, and also the extension of time was prejudicial to the defendant, thereby releasing the defendant with respect to any obligation on its bond to the plaintiff.

It is a recognized general principle that a private agreement between the creditor and a principal, giving the principal additional time to pay his then due indebtedness, will discharge the principal's compensated surety if the extension has all the elements of a binding contract, and if it prejudices the surety. This is the general rule applied in most jurisdictions (50 *Am. Jur.*, page 948, Section 61) and is the law of Kentucky. *U. S. Fidelity & Guaranty Co.* v. *Mayo Arcade Corp.*, 253 Ky. 763, 70 S. W. 2d 531; *Daviess County Bank & Trust Co.* v. *Wright*, 129 Ky. 21, 110 S. W. 361; *Bradford* v. *Union Trust Co.*, 242 Ky. 709, 47 S. W. 2d 536.

The Trial Court and the Court of Appeals felt there was no enforceable contract because there was no con-

sideration. But it is clear there is consideration, and the motion for a directed verdict and for Judgment n.o.v. should have been sustained. Even though Sanders' past due indebtedness was at common law to draw interest at the time the notes were made because of the execution and delivery of the interest bearing notes the relationship changed between Sanders and the plaintiff so as to result in Sanders giving up a valuable right which he possessed before the delivery of the Notes, and which resulted in the plaintiff's acquisition of a valuable right which it did not have before receiving the Notes.

The correctness of the defendant's position becomes readily apparent by an examination of the notes in question (99a, 102a). It is extremely important to recognize the fact that these notes are *not demand notes*, nor are they payable "on or before" a certain day. These notes are payable on a *day certain* after date. Furthermore, it is important to note that the amount payable shown on the face of the last three (3) notes is made up of a portion of the indebtedness as it existed on October 11, 1960, plus interest on that portion computed from October 11, 1960, to the due date of the respective notes. In other words, during October, 1960, Sanders' indebtedness amounted to $29,918.80 and was then immediately due and payable (55a-56a, 75a). The note transaction changed the relationship between Sanders and the plaintiff because, instead of the full indebtedness being due, $5,000.00 of the total had been deferred from October 11, 1960, to October 20, 1960 (55a-56a, 99a); $4,900.41 had been

deferred from October 11, 1960, to November 5, 1960, and $124.59 interest computed from October 11, 1960, to November 5, 1960, had been added, making the amount payable shown on the note $5,025.00 (55a-56a, 99a); $9,999.91 of the indebtedness had been deferred from October 11, 1960, to December 5, 1960, and $100.09 interest from October 11, 1960, to December 5, 1960, had been added, making the amount payable shown on the face of the note $10,100.00 (55a-56a, 102a); finally, the balance of the indebtedness had been deferred from October 11, 1960, to January 5, 1961 with interest to January 5, 1961, making the amount payable shown on the note $10,067.68 (102a). The total of the notes exceeds Sanders' total indebtedness due on October 11, 1960, by some $274.00, which, as admitted by the defendant's general credit manager, is interest incorporated into the notes (77a).

The interest feature is extremely important in this case because the interest incorporated into the notes is the element of consideration necessary to support the extension of time. As mentioned above, the Trial Court was of the opinion that since the past due account would bear interest, anyway, as long as it remained unpaid, the fact that the notes incorporated interest did not provide the necessary consideration to support the extension of time. In reaching this conclusion, the Trial Court failed to consider the fact that the interest included in the face amount of these notes was figured to a day certain, and that the legal effect of the notes was to require Sanders to pay the interest to the due date of each note. This fact gave

the plaintiff more than it had before the notes were given, because prior to the notes, the plaintiff had the right to demand interest on Sanders' unpaid account only so long as it remained unpaid; plaintiff had no right to demand interest to a day certain. Prior to the notes, Sanders could have at any time, paid the balance of the debt and thereby immediately relieved himself of the obligation to pay further interest. After giving the notes, Sanders was legally bound by their terms, which required him to pay the face amounts, which included interest to the due date of each note. In other words, Sanders was required to pay interest on this account to a day certain. It is the defendant's contention that the interest feature of these notes, payable to a day certain, is adequate consideration to support the extension of time apparent on the face of the notes.

The law governing this point is well settled. In *1 Williston, Contracts*, Section 122, we find the following:

> "When a debtor and creditor agree that an interest bearing debt shall be extended for a fixed time, the promise of each is of something detrimental, as the creditor promises to forebear the collection of his claim, and the debtor gives up his right to stop the accrual of further interest by payment of the principal at maturity."

This is the law in Kentucky. In *Robinson v. Miller*, 11 Bush (Ky.) 179, the Court of Appeals of Kentucky held that the agreement by a debtor to pay interest to a specified date on a past due obligation was considera-

tion to support the creditor's corresponding agreement to extend the time of payment. This case has neither been modified nor reversed down through the years. The argument was made in the *Robinson* case that the extension of time was not supported by valid consideration, since the law provided that 6% interest would be paid on the past due debt anyway. The Court of Appeals of Kentucky rejected this argument, and in explaining how the consideration arose, stated:

> "If the lender of money, secured by a note, after the same becomes due, contracts with the borrower that the time of paying the same shall be extended for one year or for any other period, upon consideration that the borrower shall pay the legal or less rate of interest, why is it not a binding contract? *The lender, by his contract, secures to himself the interest on his money for the year, and the borrower precludes himself from getting rid of the payment of the interest by discharging the principal. It is a valuable right to have the privilege, at any time, of getting rid of the payment of interest by discharging the principal. By this contract, the right to interest is secured for a given period and the right to pay off the principal and get rid of paying interest is also relinquished for such period.* But it is said there is no consideration for the extension of time because the law gives six per cent after the note is due. *But the law does not secure the payment of this interest for any given period, or prevent the discharge of the principal at any moment. There is precisely the same consideration for the extension of time as there was for the original loan.*" (Emphasis supplied.)

From the above, it is clear that the extension of time granted to Sanders by the plaintiff was supported by consideration, and was therefore, enforceable by both Sanders and plaintiff. In other words, these notes gave the plaintiff the right to require Sanders to pay interest until the due dates on the notes. Also, if the notes mean anything at all, they gave Sanders the right to defer payment of the account until the various due dates stated. Of course, he had to pay interest until those due dates, which was something that he would not have had to do before he gave the notes. In other words, Sanders gave up his right to pay, at any time, his indebtedness to plaintiff and thereby unburden himself of the payment of further interest, which, on $30,000.00, is a consideration not to be lightly regarded.

The Circuit Court in its Opinion made no reference to the fact that the notes involved were payable at a fixed date. Furthermore, the Circuit Court made no reference to the fact that at the time the notes were given and the extension of time granted, Sanders was solvent but at the time of the filing of the suit in the District Court, was insolvent and bankrupt. The Circuit Court ignored the interest feature of the notes, and that the Crane Company required him to agree that any payment he might make on the notes would be first applied to the portion of his total account not governed by the defendant's surety bond (11a-16a, 65a-66a, 73a). The Circuit Court and the Trial Court further ignored the fact (59a) that Sanders collected in the regular course of business after October 11, 1962

after the notes were executed the sum of Thirty-Eight Thousand Twenty-Three Dollars and Twenty-Four Cents ($38,023.24). In addition, both Courts ignored the fact that if the demand had been made by the Crane Company upon the surety at the time that the notes were executed, Sanders was solvent and the Insurance Company could have protected itself by paying and securing the sums paid Sanders by way of subrogation from the School.

In applying the Kentucky Law as above set forth, prejudice was shown by the fact that at the time the notes were given, Sanders was solvent and at the time suit was filed, he was insolvent and the surety could not protect itself. Thus, the Court has ignored the law as set forth in the above cases which is not only the law of Kentucky, but the law generally as set forth in *Williston on Contracts*.

3. Where an Unpaid Material Supplier, Who Has Furnished Materials to a Building Contractor for Use in the Completion of a Construction Contract (Pursuant to the Terms of Which the Building Contractor Has Posted a Materials and Labor Bond With Compensated Surety), at a Time When the Debt Is Past Due, But the Contractor Is Solvent, and Without Any Demand Upon a Notice to or Knowledge of the Surety, Grants the Building Contractor an Enforceable Extension of Time in Which to Pay the Debt, Does the Extension of Time Prejudice the Surety in Its Obligation on the Bond if the Contractor Becomes Insolvent During the Extension Period?

The giving of these notes created an enforceable contract as a matter of law, and the Courts were in error when they say they were given without consideration. The effect of the extension of time impaired the defendant's rights as Sanders' surety. This right was that in the event that the defendant was required to discharge Sanders' past due indebtedness to the plaintiff, the Insurance Company would have been subrogated to the rights of the plaintiff against Sanders. In *Lewis' Adm'r v. United States Fidelity & Guaranty Co.*, 144 Ky. 425, 138 S. W. 305, 306, this question was decided as follows:

> "We are cited to no authority from any court of last resort denying to a surety the right to subrogation because he was a compensated or paid surety. Subrogation is allowed because the surety has paid the debt of his principal. Upon this ground the right rests. The question as to what induced the surety to assume the obligation cannot

be considered in determining his rights. The sole question is, Has he been compelled to pay the debt of his principal? If he has, he is entitled to be subrogated to the rights of the creditor. It is common knowledge that guaranty companies have for many years been accepted as surety upon the bonds of fiduciaries, public officials, and others occupying relations of confidence and trust. Many times in innumerable instances and forms their right to subrogation has been asserted and upheld. This right, so far as we are advised, has never been questioned, and certainly not denied."

This rule has been followed in Kentucky in the more recent case of *Grubbs* v. *Slater*, 266 S. W. 2d 85, 86 (Ky.), wherein it is stated:

"In Davis v. Kinnard, 271 Ky. 428, 212 S. W. 2d 412, 414, we quoted with approval this general equitable principle appearing on page 611 in Volume 1 of Brandt's The Law of Suretyship and Guaranty, 3d Ed., which we think is in all respects applicable to the case at bar: '* * * In cases where the person paying the debt or performing the obligation of another stands in the relation of surety or guarantor to the person whose debt or obligation has been performed, equity substitutes him in the place of the creditor or obligee as a matter of course, without any special agreement to that effect and without requiring any further showing to be made of circumstances entitling him to subrogation'."

The Sixth Circuit and the Trial Court failed to follow the clear law of Kentucky in the *Grubbs* and

Lewis cases. Thus, the prejudicial action on behalf of the principal denied the surety the opportunity to protect itself by means of subrogation. In addition, the money that was collected from Sanders after these notes were executed was applied to the unbonded accounts rather than to the bonded accounts pursuant to the agreement. Thus, in effect, by connivance between the Crane Company and Sanders, the Surety Company was left holding the bag. The Circuit Court Opinion and the Trial Court did not consider this aspect of the case at all. Certainly, prejudice was shown as shown by the *Lewis* case and the failure of the lower courts to follow the Kentucky law in accordance with *Erie Railroad* v. *Tompkins*, *supra*, is the basic reason the Writ should be granted.

4. Where an Unpaid Material Supplier, Who Has Furnished Materials to a Building Contractor for Use in the Completion of a Construction Contract (Pursuant to the Terms of Which the Building Contractor Has Posted a Materials and Labor Bond With Compensated Surety), at a Time When the Debt Is Past Due and Without Any Demand Upon or Notice to the Surety, and Without the Surety's Knowledge, Grants to the Building Contractor an Enforceable Extension of Time Which Is Prejudicial to the Surety, Is the Surety Thereby Released From Its Obligation on the Bond to the Material Supplier?

The action of the Trial Court and the Opinion of the Circuit Court is contrary to *Pond Creek Coal Co. v. Citizens Trust & Guaranty Co.*, 170 Ky. 601, 186 S. W. 494 and *Bradford v. Union Trust Co.*, 242 Ky. 709, 47 S. W. 2d 536, because the granting of an extension of time without the surety's knowledge under the law of Kentucky will discharge the surety.

In *Pond Creek Coal Co. v. Citizens Trust & Guaranty Co.*, 170 Ky. 601, 186 S. W. 494, the Court of Appeals of Kentucky outlined the applicable law:

> "The general rule is that the party secured or guaranteed must exercise the utmost good faith in all of his dealings with the principal obligor and strictly comply with the terms of the contract secured, and any failure on his part to do this will result in a release of the surety. * * *"

The Court then went on to distinguish the situation between a gratuitous surety and a compensated surety.

The Court recognized the fact that the compensated surety was not entitled to the same protection as a gratuitous surety, and said that this was an exception to the general rule. However, the Court added:

> "* * * but this exception to the general rule does not go so far as to allow material changes, alterations, or nonobservances of the contract to be made without the knowledge and consent of the surety, without releasing him."

In the case of *Bradford* v. *Union Trust Co., supra*, the Kentucky Court of Appeals, in considering a situation involving an extension of time granted by a creditor to a bonded principal stated:

> "To make an extension of time to a debtor have the effect of exonerating the surety, it is not merely necessary that there should be an agreement which varies the original contract by postponing the time for its performance beyond that fixed originally by the terms of the obligation, but the transaction must involve all the essentials of a binding contract—one that the debtor may enforce against the creditor, either as a cause of action or as a defense effectually tying the hands of the creditor as regards enforcing payment of the debt until the expiration of the agreed time."

In addition the Court did not follow the law as set forth by the Kentucky Court of Appeals in *U. S. Fidelity & Guaranty Co.* v. *Mayo Arcade Corp.*, 253 Ky. 763, 70 S. W. 2d 531, 533, as follows:

"Whether or not this contract constituted a novation of the judgment or an estoppel against appellees we deem unnecessary to determine since we have concluded that it extended the time for the payment of the judgment without the consent of the surety, and that therefore the trial court erred in sustaining the demurrer to paragraph 4 of the answer which pleaded this as a defense."

* * * * * * *

"When the contract of March 15, 1932 was entered into, the surety had the privilege of paying the judgment and being subrogated to the rights of appellees. Thus it was afforded an opportunity to protect itself from loss. By the contract of March 15, 1932, the appellees for a valuable consideration deprived themselves of the right except under certain conditions to enforce the judgment according to its terms. *Thus the surety was deprived of its right of subrogation, and it could take no steps for its own protection against loss so long as the principal in the bond complied with the terms of the contract of March 15, 1932, which was entered into by appellees and the principal without the surety's consent.* The agreement extending the time of payment of the judgment and preventing its enforcement according to its terms deprived the surety of a substantial right, and therefore, released it from liability." (Emphasis supplied.)

It is respectfully submitted that in the present case the defendant must be released because the notes constituted an enforceable agreement between plaintiff and Sanders, whereby Sanders was given an extension of

time in which to pay his indebtedness. Thus, this defendant, as Sanders' surety, was deprived of its right to *immediately* pay Sanders' indebtedness to plaintiff and then become effectively subrogated to plaintiff's claim against Sanders. The loss of this right materially altered the surety's undertaking, was unquestionably prejudicial to its rights; and under the Kentucky law the defendant is entitled to be released as to any obligation on its bond to the plaintiff.

Thus, it is clear that the law of Kentucky was not followed by either the Court of Appeals or the Trial Court as they are required in matters of this kind to do by *Erie R. Co. v. Tompkins*.

CONCLUSION.

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A.

CRANE SUPPLY COMPANY, a Division of Crane Company, Plaintiff-Appellee,

v.

AMERICAN STATES INSURANCE COMPANY, Defendant-Appellant.

No. 14714.
United States Court of Appeals
Sixth Circuit.

Nov. 15, 1962.

* * * * *

Plaintiff-appellee is an unpaid material supplier that furnished building materials to a contractor for use in the completion of a construction contract for schools in Louisville, Kentucky. Defendant-appellant is a compensated surety that furnished a materials and labor bond to guarantee payment of the materials and labor used by the contractor in case of his failure to pay. Subsequently, when the contractor became embarrassed financially, he executed notes payable to the plaintiff-appellee running for a period of less than three months and bearing interest at the rate of 6% after maturity. On the trial, the jury, in answer to an interrogatory, found that the notes were not accepted by plaintiff-appellee as payment of the obligations owed to it by the contractor; and the sums owing to appellee supplier not having been paid, the jury returned a verdict in favor of the supplier against the surety.

Defendant-appellant surety company contends that it was discharged of its obligation under the surety bond for the reason that it was prejudiced by plaintiff-appellee's acceptance of the contractor's promissory notes.

The issue is whether the acceptance of the contractor's notes prejudiced the compensated surety. If the notes had been accepted by appellee material supplier in payment of the contractor's indebtedness, the surety might well have been prejudiced, because of the grant of an extension of time for paying such indebtedness; and, accordingly, the surety might, therefore, have been released from its obligation on the bond.

The evidence, adduced on behalf of appellee supplier, disclosed that when the contractor fell behind in his payments for materials to the supplier, the contractor and the supplier entered into an agreement whereby notes were given; that the contractor at that time considered he could collect all sums due him on the jobs within a period of ninety days; that the notes contained dates of payment within ninety days; that the supplier was, in any event, entitled by law to charge 6% on past-due indebtedness; that the notes bore interest at the rate of 6% after the maturity date; that it was understood that the notes were given only to evidence the indebtedness of the contractor to the supplier; that it was further agreed that, *at any time* when the contractor was entitled to payment of funds, from the School Board, on the various jobs, the contractor and the supplier would, together, go before the School Board; that, at such a time, the supplier would give a waiver of lien or release; and that, upon the furnishing of such waiver of lien or release, the money would be paid over to the supplier by the School Board.

The jury, as heretofore stated, found that the notes were not accepted by the supplier in payment of the contractor's indebtedness. In accordance with this finding in favor of appellee, it is to be concluded that, under the evidence, the jury impliedly found that the notes were taken merely to evidence the indebtedness; that they were given by the contractor to the supplier pursuant to the terms of an

agreement in which the contractor and the supplier stipulated that the amounts, set forth in the notes, were to be paid at any time the contractor was entitled to payment by the School Board; that, because of their agreement, there was no extension of any specific time granted by the appellee to the contractor for the payment of the indebtedness, and, accordingly, no consideration for any extension for payment; and that the due dates of the notes, and the interest provisions therein, did not change the agreement of the parties, that the supplier would receive payment for its materials, as soon as the contractor became entitled to payment by the School Board.

[1-3] While the foregoing have here been characterized as implied findings of the jury, the evidence in the case amply sustained such implied findings. If the evidence in support of the verdict be substantial, the implied findings of the jury will be deemed sufficiently supported. Unless the verdict is opposed to the physical facts or inherently incredible, the court on appeal will view the evidence in the light most favorable to the verdict, giving the evidence the benefit of all inferences that may reasonably and legitimately be drawn therefrom. Defendant-appellant states that it takes no issue with the jury's verdict; and it raised no objection to the trial court's instructions.

[4] The compensated surety suffered no injury or prejudice by reason of plaintiff-appellee's acceptance of the contractor's promissory notes as evidence of the amount of the indebtedness due, in accordance with the terms of the agreement between the appellee and the contractor; and, therefore, the surety is not discharged from its liability under the bond. There was no error on the part of the district court in overruling defendant-appellant's motion for a directed verdict and a motion for a judgment notwithstanding the verdict.

Accordingly, the judgment of the district court entered on the verdict of the jury is affirmed. The motion of plaintiff-appellee for an award of damages of 10% for unnecessary delay and costs, based upon the claim of a frivolous appeal, is denied.

* * * * *

JUDGMENT.

(Filed November 15, 1962)

Appeal from the United States District Court for the Western District of Kentucky.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Kentucky, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed. The motion of plaintiff-appellee for an award of damages of 10% for unnecessary delay and costs, based upon the claim of a frivolous appeal, is denied.